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In the Supreme Court of the United States

OCTOBER TERM, 1945

Nos. 361 and 362

BURTON-SUTTON OIL COMPANY, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 54–74) [1] and the dissenting opinion (R. 74–75) are reported at 3 T. C. 1187. The opinion of the Circuit Court of Appeals (R. 87–93; C. R. 110–116) and the

[1] Record references to the transcript of record in docket No. 11,275 in the Circuit Court of Appeals (No. 361 here) are referred to with the designation "R." References to the transcript in docket No. 11,285 (No. 362 here) are designated "C. R." The cases were consolidated in the Circuit Court of Appeals for hearing and disposition.

dissenting opinion of Judge Lee (R. 93–96; C. R. 116–119) have not been reported.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on July 6, 1945. (R. 97; C. R. 119–120.) The petitions for writs of certiorari were filed on August 23, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. The taxpayer acquired the working interest in an oil and gas lease, agreeing to pay 50 per cent of its net profits to the assignor of its transferor, and to pay oil royalties and overriding royalties to others. Did the court below err in affirming the decision of the Tax Court that the taxpayer was not entitled to exclude or deduct from its taxable income the share of its net profits so paid?

2. After the taxpayer had acquired the working interest in an oil and gas lease and had drilled a number of producing wells, a question arose whether the boundary lines of the property had been correctly located and whether the taxpayer's producing wells were situated on property belonging to its lessor. The taxpayer incurred expenses in establishing that the correct boundary lines were such that its working interest extended to the property in question. Did the court below err

in reversing the decision of the Tax Court and in holding that the expenses were not deductible as ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1936?

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and Regulations involved are set forth in the Appendix, *infra*, pp. 16–18.

STATEMENT

A portion of the facts in these cases (which reached the court below by cross-appeals) was stipulated by the parties. (R. 45–54.) All the stipulated facts were found, either expressly or by reference, by the Tax Court as stipulated. (R. 66.)

The taxpayer is a corporation organized in 1933 and doing business and having its principal office in Louisiana. Its books were kept and its tax returns were prepared on the accrual basis. (R. 57–58.) In 1933 taxpayer acquired the working interest in a certain oil and gas lease in Louisiana which had been executed by the Cameron Parish School Board, as lessor. (R. 58.) The taxpayer's interest in this oil and gas lease was procured from J. G. Sutton, who had obtained his interest from the Gulf Refining Company of Louisiana, referred to herein as Gulf. (R. 58.) The agreement between Sutton and Gulf, which was acquired by taxpayer, provided that Gulf (R. 46)—

> has sold, conveyed and transferred, * * * all oil and gas rights, titles, interests or

privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of Section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.

Paragraph 1 of the agreement set forth the drilling obligations of the grantee. (R. 46.) Paragraphs 2 and 3 provided that the grantee should pay all oil and gas royalties as well as overriding royalties; after being reimbursed for all expenses from the remaining oil, the grantee was to pay the grantor 50 per cent of his net earnings from the wells. (R. 47, 59–60.)

Paragraph 5 of the contract specified what costs and expenses could be deducted from the gross proceeds before division of the net profits was required to be made. (R. 48–49, 60.) Paragraph 7 provided that Gulf should not be obligated to pay any of the costs or expenses incurred by the grantee in his operations under the agreement. (R. 49–50, 60.) Paragraph 8 provided that the grantor retained all rights to sulphur in the property. (R. 50.) The final paragraph of the agreement specified the manner in which the oil produced from the land was to be sold and gave Gulf the right to purchase the oil at the average posted price, if it so desired. (R. 50–51.)

The Commissioner determined that the share of the taxpayer's net profits which was paid to Gulf was neither excludable nor deductible from taxpayer's taxable income since it represented part of the capital cost of the taxpayer's oil and gas interest, recoverable through depletion. (R. 14–15, 61.) The Tax Court upheld the Commissioner's determination in this respect and on taxpayer's petition for review its decision on this issue was affirmed by the Circuit Court of Appeals, Judge Lee concurring.

The taxpayer drilled about 19 producing wells under the lease mentioned above and had an annual gross income therefrom in excess of $1,000,000 during the years 1937 and 1938. (R. 63.)

Preparatory to a proposed proceeding by the United States to acquire certain land in the area by condemnation, the Bureau of Biological Survey of the Department of Agriculture had made a survey in 1936. The effect of this survey was to move all north and south section lines in the area several miles to the west. This, if officially accurate, would have resulted in a complete lack of title in the State of Louisiana and the Cameron Parish School Board to the territory on which taxpayer's producing wells were actually located. Also, the taxpayer would have had no rights in the area in which exploitation had been taking place. (C. R. 7–9, 13–14; R. 63–65.) Instead,

the taxpayer would have had a valueless lease to barren prairie land, and the Orange Cameron Land Company would have been the owner of the property where the oil deposits were located (C. R. 9, 14, 19; R. 64–65.)

The taxpayer employed a law firm to establish that the survey of the Department of Agriculture was a miscalculation and that the one under which the taxpayer claimed title to the underlying oil and gas was exact. (R. 64–65.) The United States filed its petition for condemnation in 1937, describing the land to be taken in accordance with the Department of Agriculture's survey. (R. 62–63.) The condemnation petition provided that the estate to be appropriated for the public use was the full fee simple title, subject to existing mineral, gas, and oil rights. (C. R. 44.) The taxpayer successfully proved to all interested parties that the section lines established by the Department of Agriculture's survey were inaccurate and that the proper boundary lines were those under which the taxpayer's lessor claimed. (R. 64–65.) The taxpayer, the Cameron Parish School Board, and the State of Louisiana were parties to the condemnation proceeding; in accordance with an agreement of all interested parties, the judgment of condemnation described the property taken in accordance with the existence of the section lines as contended for by taxpayer. (R. 65.)

During the taxable year ended February 28, 1938, taxpayer expended $27,564.61 for legal expenses in this matter. It deducted this amount in its tax return as an ordinary and necessary business expense, but the deduction was disallowed by the Commissioner on the ground that the disbursements were capital expenditures. (R. 65–66.) The Tax Court ruled, five judges dissenting, that these outlays were deductible as ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1936. On the Commissioner's petition for review the Circuit Court of Appeals, Judge Lee dissenting, reversed the Tax Court on this issue, holding that the expenditures were capital in nature and not deductible under Section 24 (a) (2) of the Revenue Act of 1936 and Article 24–2, Treasury Regulations 94.

DISCUSSION

1. The Circuit Court of Appeals decided that the taxpayer could not exclude from its taxable gross income or deduct as a business expense certain payments which it made, consisting of 50 percent of its net profits derived from a working interest in an oil and gas lease. The taxpayer, in acquiring its working interest, became obligated to make these payments to its transferor's assignor, and also became obligated to pay certain underlying and overriding oil royalties. (R. 59–60.)[2]

[2] See footnote 1, *supra*.

In holding that the net profit payments could not be excluded from the taxpayer's gross taxable income, the decision in this case would appear to conflict in principle with the decisions of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner v. Felix Oil Co.*, 144 F. 2d 276, and in *Commissioner v. Crawford*, 148 F. 2d 776, certiorari applied for, No. 197, this Term. Because of this conflict and because of the granting of certiorari on May 21, 1945, in *Kirby Petroleum Co.* v. *Commissioner*, No. 56, this Term, the Commissioner, while believing the decision below to be right, does not oppose the granting of a writ of certiorari in No. 361 to review this issue.

The issue presented by the *Kirby* and *Crawford* cases is whether a lessor is entitled to a deduction for depletion with respect to net profit payments received from his lessee. While formal distinctions might be drawn between the issue there whether the net profits received constitute a depletable interest in the lessor and the issue here whether net profits paid by an assignee constitute part of his income from the property, we believe that it is well settled that such formal distinctions have no material bearing on the question and that the same basic principles determine to whom the gross income from the property is attributable for tax purposes and by whom the depletion deduction may be taken with respect to such gross income. *Anderson* v. *Helvering*, 310 U. S. 404,

407, 411. Accordingly, the ultimate decision of this Court in the *Kirby* case may be decisive of the exclusion issue presented in No. 361.

2. In No. 362, the court below decided that the taxpayer was not entitled to a deduction for certain expenditures since they did not constitute ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1936 (Appendix, *infra*). These expenses, which the court below held to be of a capital nature under Section 24 (a) (2) of the Revenue Act of 1936 and under Article 24–2, Treasury Regulations 94 (Appendix, *infra*), were incurred by the taxpayer in an effort to prove that a survey made by the United States Government was erroneous. The Government's survey, if accurate, would have moved the section lines in this particular area in such a way that the oil and gas wells which were operated by taxpayer would have been located on property belonging to someone else and the taxpayer's lease would have become valueless. (R. 63–65; C. R. 7–9, 13–14, 19.) The taxpayer succeeded in proving that the Government's survey was in error and that the survey under which it claimed was correct. As the court below properly observed (C. R. 112), the expenditures were not made to protect taxpayer's interest against condemnation, for the condemnation petition expressly excluded mineral leases (C. R. 44, 54–55); the expenditures were made to confirm title, and under the ap-

plicable Regulation (*infra*, p. 18) they constitute capital expenditures and not deductible business expenses.

The decision on this issue does not present a question requiring further review by this Court.

A. The court below did not, as alleged (Pet. 3, 4–5, Br. 7, 8–9),[3] substitute its own findings of fact or its own inferences for those expressly made by the Tax Court. Thus, the Tax Court found (R. 63–64, 65):

> The Bureau of Biological Survey of the Department of Agriculture made a survey of the 139,000 acres preparatory to acquiring the land. Early in 1936 petitioner learned that the survey made by the Bureau of Biological Survey had the effect of moving all north and south section lines in Township 14 South, Range 13 West, about three miles to the west. This would have had the effect of leaving the oil field which petitioner had developed in what it contended was Section 16 in a section three miles to the east.
>
> * * * * *
>
> In the above-mentioned suit there had been no question as to the validity of petitioner's lease with the Cameron Parish School Board. The only question involved in so far as petitioner was concerned was the location of Section 16, Township 14 South,

[3] This and succeeding references are to the petition and supporting brief in No. 362.

> Range 14 [?] West, and the boundaries thereof. If Section 16 were located on the ground where the Bureau of Biological Survey contended it was, petitioner would have a lease on barren prairie land with no production, whereas if it were where petitioner contended it was the lease would be on land with 19 producing wells. If petitioner had lost, it would have lost its entire oil field and the income therefrom. The final judgment placed the boundary of said Section 16 just as petitioner had contended it should be placed, namely, in accordance with the survey made by Shutts in 1924 and 1925.

It is significant that the taxpayer has never contended, and does not now contend, that its right to extract oil from the leased property was subject to appropriation in the condemnation proceeding or that its expenditures were made to prevent or resist a threatened taking of this right. Any such contention would contradict the established facts. We agree with the taxpayer's assertion (Br. 10) that "The expenditures went solely to prove the error in the Government survey."

To the extent that the Tax Court, in its opinion, relied on the assumption that the taxpayer's property would have been "taken" if the United States had prevailed in its original condemnation petition (R. 73) or assumed that the expenditures were incurred because the taxpayer's efforts were directed "to prevent its property being taken"

(R. 74), it manifestly disregarded its own findings of fact and the undisputed evidence.

The taxpayer also contends (Pet. 4, Br. 7, 8, 9) that the Circuit Court of Appeals, in concluding that the condemnation proceeding did not threaten to take any property rights of the taxpayer, disregarded the stipulation entered into by the parties, particularly the provision that the taxpayer incurred "legal expenses in resisting proceedings instituted by the United States of America on certain of its property." (R. 52–53.) The stipulation, it may be noted, does not state that the taxpayer resisted an appropriation or taking of its property interest. We do not believe that any inconsistency exists or that any was intended, especially since the stipulation was filed at the hearing of October 25, 1943 (R. 45), after the testimony and exhibits (taken by deposition) introduced by the taxpayer had been filed with the Tax Court on October 8, 1943 (C. R. 5). But if there were any inconsistency, the taxpayer could scarcely complain if the facts were taken to exist as indisputably shown by its own evidence (C. R. 5–93), especially since the Tax Court itself found the facts in accordance with that evidence, as shown from the excerpt quoted above.

We submit that the Circuit Court of Appeals did not exceed its powers of review under Section 1141 (c) of the Internal Revenue Code (26 U. S. C. 1940 ed., Sec. 1141). It accepted the

facts as they were expressly found by the Tax Court. Whether the applicable provisions of the statutes and Regulations preclude the deduction in such circumstances is a matter within the province of the reviewing tribunal. *Trust u/w of Bingham* v. *Commissioner,* decided by this Court June 4, 1945, not yet reported. Moreover, to the extent that the Tax Court, in its opinion, made assumptions which lacked any warrant either in the record or in its own findings, the conclusions which it drew concerning the nature of the expenditures were not entitled to the same deference which they ordinarily would receive.

B. No conflict in decisions is presented. *Commissioner* v. *Reakirt,* 84 F. 2d 996 (C. C. A. 6th), affirming *per curiam* 29 B. T. A. 1296, relied on by the taxpayer (Pet. 4, 5, Br. 9–10), differs from the present case in every material respect. In the *Reakirt* case there was no issue respecting the taxpayer's title to the property. Here, the only matter with which the taxpayer was concerned related to the validity of its title to the underlying oil in the place where its wells had been drilled; the expenses were incurred to remove the cloud which had been cast on its chain of title by the Government's survey. In the *Reakirt* case the expenses were incurred to prove that the condemning authority had no legal right to take the taxpayer's property. In the present case there was no dispute concerning the authority of the

United States to take whatever surface land it needed and the taxpayer here never contested any taking by the United States. In the *Reakirt* case, if the taxpayer had not prevailed in the litigation, he would have received fair compensation from the condemning authority for the taking. If the taxpayer here had not been able to prove the invalidity of the Government's survey, it would have lost its rights to the oil where located and, instead, would only have had a valueless lease to barren ground. By proving that the Government's survey was inaccurate, the taxpayer here was able to perfect its title to the underlying oil.

Thus, the *Reakirt* decision has no bearing on expenses incurred to perfect title by removing a cloud which has been cast on it. Although we believe that the *Reakirt* case itself was decided erroneously, it does not conflict with the decision in the present case. In addition, it should be observed that the provisions of the applicable Regulations were less clearly controlling in the *Reakirt* case than they are in the situation presented here. Indeed, Article 24–2, Treasury Regulations 94 (Appendix, *infra*) expressly declares that "The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense." The applicable decisions unanimously support this provision of the Regulations by holding that expenditures incurred to establish the validity of one's title or to defend against attacks made upon

it are not deductible business expenses. *Jones' Estate* v. *Commissioner*, 127 F. 2d 231 (C. C. A. 5th); *Farmer* v. *Commissioner*, 126 F. 2d 542 (C. C. A. 10th); *Owens* v. *Commissioner*, 125 F. 2d 210 (C. C. A. 10th), certiorari denied, 316 U. S. 704; *Moynier* v. *Welch*, 97 F. 2d 471 (C. C. A. 9th); *Brawner* v. *Burnet*, 63 F. 2d 129 (App. D. C.); *Croker* v. *Burnet*, 62 F. 2d 991 (App. D. C.); *Blackwell Oil & Gas Co.* v. *Commissioner*, 60 F. 2d 257 (C. C. A. 10th); *Hutchings* v. *Burnet*, 58 F. 2d 514 (App. D. C.); *Murphy Oil Co.* v. *Burnet*, 55 F. 2d 17 (C. C. A. 9th), affirmed without consideration of this point, 287 U. S. 299. See also *Schwabacher* v. *Commissioner*, 132 F. 2d 516 (C. C. A. 9th). The decisions in *Kornhauser* v. *United States*, 276 U. S. 145, and *Commissioner* v. *Heininger*, 320 U. S. 467 (Pet. 5, Br. 10), plainly do not deal with the question of the capital nature of an expenditure of this kind.

CONCLUSION

The Commissioner does not oppose the granting of a writ of certiorari in No. 361 (issue 1, *supra*). The granting of certiorari in No. 362 (issue 2, *supra*) is opposed since the decision below is correct and no conflict of decisions is presented; accordingly, the petition therein should be denied.

Respectfully submitted.

HAROLD JUDSON,
Acting Solicitor General.

SEPTEMBER 1945.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases

to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * * *

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

* * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

(b) *Basis for Depletion.*—

* * * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * * *

The provisions of Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1934, c. 277, 48 Stat. 680, are identical with the corresponding sections of the Revenue Act of 1936.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 24–2. *Capital expenditures.*— Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (l).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. * * *

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